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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 244

DEWEY SCHMOLL, Successor Assignee for the Benefit of Creditors of Murch Bros. Construction Company, and National Surety Corporation,

Petitioners,

vs.

THE UNITED STATES

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

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STATUTE

Section 3466, R. S., 31 U. S. C. Sec. 191 2

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1946

No. 244

DEWEY SCHMOLL, Successor Assignee for the Benefit of Creditors of Murch Bros. Construction Company, and National Surety Corporation,

Petitioners,

vs.

THE UNITED STATES

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

The petitioners pray that a writ of certiorari be issued to review the judgment of the Court of Claims of the United States entered in the above entitled case on January 7, 1946.

Opinions Below

The opinion of the Court of Claims (R. 64) is not yet officially reported.

Jurisdiction

Judgment in the Court of Claims was entered January 7, 1946 (R. 72), and petitioners' and defendants' motions for new trial were overruled April 1, 1946 (R. 73). The

jurisdiction of this Court is invoked under Section 3(b) of the Act of February 13, 1925, as amended.

Questions Presented

1. Whether the equitable lien and the contractual rights of the National Surety Corporation, the surety on the contract bonds of the defaulted contractor, upon which bonds the surety has suffered substantial losses by payment of labor and material claims, entitles the surety to receive the balance of the contract price in the hands of the United States, without the United States first deducting therefrom, under the claimed authority of Section 3466 R. S., a sum to compensate the United States for capital stock taxes owed by the defaulted contractor, and for losses suffered by the United States under two contracts which were not covered by the bonds of National Surety Corporation.

2. Whether the Comptroller General has the right to deduct, under the claimed authority of Section 3466, R. S., taxes and other debts of the contractor, not related to the contract bonded, against the surety's interest in the contract price.

Statute Involved

The provisions of Section 3466, Revised Statutes, 31 U. S. C. 191, are quoted in the appendix, page 18.

Statement

Between November 18, 1933, and March 11, 1935, the contractor, Murch Brothers Construction Company, entered into 17 contracts with the United States for the construction of post office buildings in various parts of the United States. Petitioner, National Surety Corporation, executed bonds conditioned for the performance of these 17 contracts and the payment of labor and materials, pursuant to the

Act of August 13, 1894, amended February 24, 1905, known as the Heard Act. The contractor defaulted under these contracts after completing a large part of the work and the United States thereupon took over and completed the work (R. 35). After deducting from the original contract prices all expenses of completing the 17 contracts there remained in the hands of the United States a balance of contract funds in amount of $22,505.01.

The National Surety Corporation, as surety on all 17 contracts, paid all outstanding claims of labor and materialmen left unpaid by the contractor, and suffered a loss thereby of $202,011.66 (R. 47). The Court of Claims, however, in rendering judgment in the surety's favor, offset against the balance of $22,505.01 referred to, the sum of $2,552.43, the cost of correcting defective work under two contracts (not included in the 17 contracts mentioned above) which the contractor had with the United States through the Veterans' Administration. The National Surety Corporation was not the surety on those two Veterans' Administration contracts and was not a party to any of the transactions in relation thereto (R. 46).

The Court of Claims further offset against the balance of $22,505.01, the sum of $206.53, unpaid capital stock tax assessed for the year 1935 against the contractor, making a total offset of $2,758.96 against the said balance (R. 47-48). It is contended by the surety that these two deductions were improper as a matter of law.

Specifications of Errors To Be Urged

The Court of Claims erred:

1. In not recognizing that the National Surety Corporation had an equitable lien upon the balance of the contract price in the hands of the United States, which equitable lien, under the decisions of this Court, the Federal Courts

and the Court of Claims, was superior to any claims of the United States as a creditor of the contractor.

2. In not recognizing that the United States owed a contractual duty to the surety, not to vary the terms of the suretyship contract by diverting part of the contract price to the payment of debts of the principal not covered by the bonds.

3. In not recognizing that the surety, by reason of its payment of labor and material bills owed by the defaulted contractor, became subrogated to the rights of the labor and materialmen, and to the equitable lien which they have in their own right, as well as to the rights of the United States, in the balance of the contract price.

4. In holding that the United States had the right to deduct from the balance of the contract price in its hands an item of $206.53 capital stock tax owed by the defaulted contractor, as against the interest of the surety who has paid the contractor's labor and material men.

5. In holding that the United States had the right to deduct an item of $2,552.43 from the balance of the contract price in its hands, against the interest of the surety who has paid the contractor's labor and materialmen, which item represented a loss by the United States on two contracts of the defaulted contractor bonded by sureties other than National Surety Corporation was not the surety.

6. In not recognizing that the balance of the contract price was not a part of the assets of the contractor, and therefore, Section 3466 of the Revised Statutes gave the United States no right to said balance against the property right therein of the surety.

7. In not recognizing that the liability of a surety on a Government contract bond extends only to the performance

of that particular contract and to the payment of labor and materialmen thereon.

Reasons for Granting the Writ

The bonds involved in this case are typical of those required on all Government contracts. The Comptroller General in recent years has made a practice of deducting from contract balances in the Government's hands, taxes and other debts of the contractor, not related to the contract bonded, but owing to the United States by the defaulted contractor, in cases where a surety has either completed a contract defaulted by the contractor or paid the labor and material bills left unpaid by the contractor. The Comptroller General claims the authority to make such deductions under Section 3466 R. S. (Appendix p. 25).

The Court of Claims, in the case of *Maryland Casualty Company* v. *United States,* 100 C. Cls. 513, held that the United States could not offset taxes owed by the contractor against the contract balance, against the surety's interest in the money. The Court of Claims then held, in the instant case, that the United States could make such an offset where the surety had suffered losses under its *payment* bond, but did not decide what the situation would be if the surety's loss had been under its *performance* bond. The result of this conflict is that the Comptroller General refuses to follow the *Maryland Casualty Company* case, stating his position in Case No. B-41334, dated April 18, 1946, to be:

> "This office does not consider the holding in the Maryland case a controlling precedent with respect to the right of subrogation of a surety to amounts otherwise due from the United States, as against the right of the Government, to set off, out of such funds, moneys due from the surety's defaulting principal.
>
> • • • • • • •
>
> While the General Accounting Office accords 'persuasive weight' to the decisions of the Court of Claims

and of other inferior Courts, only decisions of the Supreme Court are considered binding."

The question involved, therefore, in its essence, is whether the surety on performance and payment bonds can, in effect, be made to pay the debts of the contractor to the United States for taxes, or for any other debts, not related to the project which the surety bonds.

In the instant case, the amount of the debts of the contractor deducted by the Government is small, but if the Court of Claims' interpretation of Section 3466 Revised Statutes is correct there is no limit to the character or amount of the contractor's debts that can be charged against the surety's interest in the contract price. As an illustration, a contractor may owe no taxes to the Government at the time of execution of the bond and contract but after his income tax report is audited by the Government, he might be assessed with a large deficiency; no surety could or would anticipate this hidden liability when it wrote the bond. The consequences of the decision of the Court of Claims in the instant case, and the present ruling of the Comptroller General, are far reaching and involve an interpretation of Section 3466 never heretofore placed upon that section and never intended to be placed on that section.

The surety, in consideration of writing performance and payment bonds, looks to its equitable lien and right of subrogation to the equitable rights of labor and materialmen, and its subrogation to the rights of the United States, to insure that the full contract price agreed to be paid by the United States will be available to complete the work, and to reimburse the surety for its payments to labor and materialmen. This will not be so if the Comptroller General has the right, under R. S. 3466, to deduct miscellaneous debts, taxes and others, from the balance of the contract price in the Government's hands.

The Comptroller General takes the position that he will be bound only by a decision of the Supreme Court on this important subject.

It will be seen, therefore, that: (1) *the Court of Claims has decided an important question of Federal Law which has not been but should be settled by this Court;* (2) *its decisions in the Maryland Casualty case and the instant case are conflicting, leaving in doubt an important question of Federal law;* (3) *the decision of the Court of Claims relates to the construction of a statute of the United States, R. S. 3466, which has not been but should be settled by this Court.*

The surety who has paid labor and material claims under its bond has an equitable lien attaching to the contract price, which lien is superior to the claim of the United States as a general creditor for taxes and other debts owed it by the defaulted contractor

The landmark case delineating the equitable rights of a surety when, after the contractor's default, it fulfills the obligation of its bond, is *Prairie State Bank* v. *United States,* 164 U. S. 227. This case originates the doctrine of the equitable lien arising in favor of the surety who answers for the debt, default or miscarriage of another, which equitable lien attaches directly to the balance of the contract price remaining in the hands of the obligee, relates back to the date when the surety made its bond, and is superior to the claims of any creditor, including the United States. Hereafter the superiority of the surety's equitable rights, thus defined, over the unsecured claim of the United States for taxes and other debts owed by the contractor, asserted under Section 3466, Revised Statutes, will be shown.

The doctrine of the *Prairie State Bank* case has been followed consistently in all the courts.

In *Farmers Bank* v. *Hayes, et al.*, 58 F. (2d) 34 (C. C. A. 6), that court said:

> "This is on the principle that a surety who gives bond to the owner to insure performance of a building contract by the contractor's is subrogated to the rights of the *owner* in the percentage which the owner retains as security for the performance of the contract; that when the contractor performs his obligation to the owner, but fails to pay labor and material men, and the surety is subrogated to liens of laborers and material men upon the fund reserved by the owner."
>
> "*Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404; *Belknap Hardward Manufacturing Company* v. *Ohio River Contract Company*, 271 Fed. 144; *Exchange State Bank* v. *Federal Surety Company*, 28 Fed. (2d) 485 (C. C. A. 8)."

The retained portion of the contract price is as much for the benefit of those furnishing labor and material as it is to insure performance of the work, and the surety, upon payment of the claims of labor and material men becomes subrogated to their rights in the balance of the contract price.

In the instant case, the Court of Claims advanced a theory that is directly in conflict with the cases just cited, with the *Maryland Casualty Company* case, 100 C. Cls. 513, as well as with other Federal cases referred to below.

The theory is that inasmuch as the plaintiff only paid *material* bills, whereas the money withheld by the United States was to secure *performance* but was not withheld to insure payment to laborers and materialmen, the surety had no right to that part of the contract price, since it

> "* * * was not retained to secure performance of the obligation the surety discharges."

Compare this point of view with the *Farmers' Bank* case, as follows:

> "But whether in the instant case the surety's rights arise out of subrogation to the rights of the Board of Trust (the obligee) or of the equitable liens of the laborers and materialmen, the result is the same. In either case, the equitable rights of the surety become fixed as of the date of the bond, and are superior to those of any holder of any after acquired lien. Whether the lien of the surety extends only to the reserved percentage under the contract, or also to sums earned under the contract, and retained by the owner, is a question which has frequently been raised. We think it is now settled that it extends to both."

The cited case held, plainly enough, that the surety's right is an equitable lien which attaches to the *contract price*, and became fixed as of the date of the bond.

Compare, furthermore, the Court of Claims' langauge in the instant case, that the contract money

> "• • • was not retained to secure performance of the obligation the surety discharges."

with the court's own language in the *Maryland Casualty* case, 100 C. Cls. 513, 522,

> "• • • But when the surety pays the laborers and materialmen, it is performing the contract as much as when it completes the building. We see no more reason why the parties should intend that, either under the guise of building the building, or of paying laborers and materialmen, both of which the surety has promised will be done, it should in reality, and because of the ease of bookkeeping, be paying the contractor's taxes or other debts, which it has not promised will be done."

Also:

> "We construe the bond and the transaction as a whole as implying a promise on the part of the Govern-

> ment to the surety that it will not so settle the accounts of the contractor as to leave the surety in the position of paying the contractor's taxes."

This brings into sharp focus the conflict in the Court of Claims.

It certainly is a novel proposition of law that a surety may have an equitable lien in the contract price when it loses under its performance bond but not when it loses under a payment bond. In the instant case, incidentally, the distinction between performance bond and payment bond does not exist because the bonds actually involved are *performance* bonds given under the now repealed Heard Act. There are no *payment* bonds, as such, involved in this case.

This Court reached the conclusion in *Martin* v. *National Surety Company,* 300 U. S. 588, pages 597, 598, • • •

> "That the failure to pay materialmen was a default of such a nature as to impose a duty on the contractor to turn over the payments to the surety upon appropriate demand. There is argument to the contrary. According to that argument, the moneys were to be assigned in the event of default in the performance of the contract between the contractor and the Government, and not upon failure to pay persons other than the Government who had claims against the contractor for materials or labor. But the statute directs that a bond for the prompt payment of materialmen and laborers shall be executed by the contractor before the commencement of the work. Not only that, but the contract with the Government, which was drawn in the standard form, is a confirmation and adoption of the statutory duty. The terms of the bond are read into the contract, and there is default under the contract when there is default under the bond."

In *United States Fidelity and Guaranty Company* v. *Sweeney*, 80 F. (2d) 235 (C. C. A. 8) the court said:

> "• • • Laborers and materialmen, however, have an equitable right to payment from funds due a contractor on a public improvement, in preference to general creditors. Belknap Hardware and Manufacturing Company *v.* Ohio River Contract Co. (C. C. A. 6), 271 Fed. 144. The statutory requirement of a bond to protect them is not inconsistent with such equitable rights. American Surety Co. *v.* Westinghouse Elec. Mfg. Co., (C. C. A. 5), 75 Fed. (2d) 377. There is a recognized equitable right of unpaid furnishers of labor or materials to such part of the contract price as may remain in the possession of the Government after the completion of the work by the contractor. Riverview State Bank *v.* Wents, (C. C. A. 8) 34 Fed. (2d) 419; Henningsen v. United States Fidelity and Guaranty Co., 208 U. S. 404, 28 S. Ct. 389, 52 L. Ed. 547; Farmers' Bank *v.* Hayes (C. C. A. 6), 58 Fed. (2d) 34; American Surety Co. *v.* Westinghouse Elec. Mfg. Co. (C. C. A. 5), 75 Fed. (2d) 377.
>
> "Appellant was bound by contract to pay the claims for labor and material, and upon paying these claims it was entitled to be subrogated to the superior equities of the laborers and materialmen, and when payment was made, its rights related back to the time of making the contracts. Prairie State Bank *v.* United States, 164 U. S. 227, 17 S. Ct. 142, 145, 41 L. Ed. 412; Henningsen *v.* United States Fidelity and Guaranty Co., 208 U. S. 404, 28 S. Ct. 389, 52 L. Ed. 547; London and Lancashire Indemnity Co. *v.* Endres (C. C. A. 8) 290 Fed., 98; in re: Scofield Co. (C. C. A. 2), 215 Fed. 45; Farmers' Bank *v.* Hayes (C. C. A. 6), 58 Fed. (2d) 34."

In *Morgenthau, Secretary of the Treasury, et al.* v. *Fidelity and Deposit Company of Maryland*, 94 Fed. (2d) 632, 68 App. D. C. 163, the surety claimed the balance of the contract price.

> "By subrogation on account of the money paid out by it to complete the contract and discharge the claim,

> the Court held that the surety's advance to the contractor and its payment to the laborers and materialmen released the contractor from his obligations under the contract and, as this Court said in Henningsen *v.* U. S. F. and G Company, 208 U. S. 404, likewise released the Government from all equitable obligations to see that the laborers and supplymen were paid. The surety thereby becomes subrogated to the equity of the United States. Its action created in itself an equitable right which entitled to demand and receive the balance due from the United States, and this equitable right, as this Court said in Prairie State Bank v. U. S., 164 U. S. 227, arose from and related back to the date of the original contract of suretyship. * * *"

The authorities cited above demonstrate conclusively the unassailable right of the surety to the contract price.

The true nature of the right of the unpaid materialmen to the contract price, and the equitable obligation owed them by the United States to apply the contract price in their favor is shown by *Philadelphia National Bank* v. *McKinlay,* 72 Fed. (2d) 89 (U. S. App. D. C.). This was a suit in equity by those who had furnished labor and material to a Government contract, the purpose of which suit was to *secure from the Government* the balance of the contract price for distribution among them.

The Court held that the balance of the contract price:

> "* * * Is earmarked with the claims of all persons furnishing supplies and labor on the contract, and this is true because, *irrespective of the statutory bond, those persons who furnish labor and do work on a Government project have an equitable lien on the fund for the payment of their work and labor* until the fund is paid to the contractor" (Italics supplied).

This case shows that the retained part of the contract price is withheld by the United States just as much for the

protection of laborers and materialmen as to insure performance of the contract work. This case is a direct answer to the Court of Claims' position in the instant case that the retained amount

> "• • • was not retained to secure performance of the obligation the surety discharges."

namely, payment of the claims of laborers and materialmen.

The surety is a party to the contract with the United States and has a legal right in addition to his equitable lien, to receive from the United States the balance of the contract price

In *Martin* v. *National Surety Company*, 300 U. S. 588, this Court said that the terms of the bond are read into the contract, and there is default under the contract when there is default under the bond. This authority shows clearly the legal status of the surety as a party to the contract entitled to receive the balance of the contract price after default of the contractor.

It is well settled that there are reciprocal obligations, moving between the surety and the obligee, the United States in this case, proving the existence of a contract on the part of the United States to the surety that the United States will do nothing to injure or impair the surety's rights under the suretyship agreement.

The bonds in the instant case were conditioned for the performance of the work and payment of labor and material bills. Therefore, the only obligations assumed by the surety were these two.

The reciprocal obligation of the United States was to see that the contract funds were applied to the construction of the building, which necessarily included payment of labor and material bills. This obligation prevented the

United States using the contract money for any other purpose. As this Court said in *American Surety Company* v. *Greek Catholic Union,* 284 U. S. 563,

> "It (the Greek Catholic Union) cannot now ask that the bond be rewritten to cover an event not therein specified or contemplated."

The payment by the United States, out of the contract money, of the debts of the contractor for taxes and losses on other contracts not bonded by National Surety, was not contemplated by the parties when the bonds were written, and was a clear violation of the Government's contractual obligation to the surety not to divert the contract funds for any other purpose than intended by the parties.

In *American Surety Company* v. *Greek Catholic Union, supra,* this Court further stated:

> "Where an insured undertakes to substitute a new obligation—thus substituting a new and different liability from any undertaken in the instrument of suretyship and depriving the insurer of the right of subrogation, such conduct operates to discharge the obligation of the indemnity contract."

In the instant case, the United States, by diverting the contract funds to the payment of debts of the principal on other contracts, and taxes due the United States, was clearly substituting a "new and different liability from any undertaken in the instrument of suretyship," and deprived the petitioner of the right of subrogation.

There was nothing in the bonds in this case which required petitioner to pay the debts of its principal for which the Government made deductions.

United States v. *Hodge,* 6 How. 279, states that the principle on which suretys are released,

> "Is founded upon the restriction of the rights of the suretys by which they are supposed to be injured."

The diversion of the contract funds to pay debts of the principal not covered by the bond, was an injury to the surety. By such action the surety was deprived of his right of subrogation to these funds.

Had the surety, upon default of the contractor, completed the contract work, there is no doubt that it would have had the right to recover from the United States the money so earned. The Court of Claims said, in the *Maryland Casualty Company case,* 100 C. Cls. 513:

> "But when the surety pays the laborers and materialmen, it is performing the contract as much as when it completed the building. We see no more reason why the parties should intend that, either under the guise of building a building, or of paying laborers and materialmen, both of which the surety has promised will be done, it should in reality, and because of the ease of bookkeeping, be paying the contractor's taxes or other debts, which it has not promised will be done."
>
> "We construe the bond and the transaction as a whole as implying a promise on the part of the Government to the surety that it will not so settle the accounts of the contrator as to leave the surety in the position of paying the contractor's taxes."

The Court also said in that case:

> "We think that in no case is it intended that the surety transaction should work out in such a way that the surety has paid the contractor's taxes or unrelated debts to the Government."

It is clear from the above, that the Court of Claims recognizes the contractual obligations flowing from the United States to the surety, not to vary the terms of the contract, or to impose upon the surety any obligation greater than contemplated by the bond.

This case also illustrates the point that where the surety pays the labor and material bills, instead of taking over and

completing the work, the rule is the same; since in taking over and completing the work, the surety would be required to pay labor and material bills.

Inasmuch as it is perfectly clear that a contract exists between the United States and the surety, which obligates the United States not to vary the terms of the contract between it and the surety, by diverting the contract funds to other purposes, Section 3466, R. S., has no application whatsoever in the instant case. Because of the contractual relationship, between the United States and the surety, the contract funds are in a different class than any other funds, and, therefore, are not subject to the provisions of Section 3466, R. S.

The Surety is Subrogated to the Rights of the United States

The surety making payment under its bonds is subrogated to the rights of the United States. *Farmer's Bank* v. *Hayes, et al.*, 58 Fed. (2d) 34 (C. C. A. 6). *Morgenthau* v. *Fidelity and Deposit Company*, 94 Fed. (2d) 632, 68 App. D. C. 163.

The equitable claim of the materialmen, to which the surety is subrogated, is superior to the claims of general creditors. *U. S. F. and G. Company* v. *Sweeney*, 80 Fed. (2d) 235 (C. C. A. 6).

The claim of the United States for taxes owed by the contractor is subordinate to the surety's property right in the contract price

This Court has never decided a case wherein the United States has asserted, under the claimed authority of Sec. 3466 R. S., the right to offset against the balance of the contract price due the surety, miscellaneous debts, including taxes, owed by the contractor in default. Some recent lower court cases on the point, however, are helpful.

In re Van Winkle, 49 F. Supp. 711 (D. C. W. D. Kentucky, 1943), the contractor completed the building but failed to pay certain bills for labor and materials. The surety paid the claims, but not before the United States had filed a lien for taxes due by the contractor. Both the surety and the United States claimed the fund in the hands of the owner, the United States claiming under Section 3466, R. S. The Court recognized the surety's equitable lien and decided in its favor.

In *New York Casualty Company* v. *Zwerner,* 58 Fed. Supp. 473 (D. C. N. D. Ill. E. D.), the contractor defaulted in the payment of labor and material bills, which the surety paid. The Collector of Internal Revenue filed a lien against the National Housing Agency, to attach the final payment in its hands. The Court held the surety entitled to the money ahead of the Collector of Internal Revenue, saying:

> "The tax Collector by his notice of lien and levy can have a lien only upon funds due to the contractor and, since labor and material claims, and possible other claims, as heretofore set forth, will absorb more than the balance due the contractor on said construction contract, there is no fund upon which the tax collector's lien or levy can attach. This suit does not put in issue the amount of the taxes or the propriety thereof, but seeks simply to prevent the taking of money belonging to the plaintiff to pay the taxes of someone else."

See also *Heintzelman Construction Company,* 34 Fed. Supp. 109 (D. C. W. D. N. Y.), where the Collector of Internal Revenue had filed a claim with the trustee of the bankrupt contractor. The court directed the trustee in bankruptcy to apply the contract money to the payment of various claims for material furnished and labor performed for such work, holding that as to a claim of the United

States for social security tax, its priority rights under the Bankruptcy Act are limited to priority as between creditors of the estate, and that the contract fund was a *trust fund* and never became part of the estate.

The unsecured claim of the United States under Section 3466 R. S. is inferior to the property rights of the surety in the balance of the contract price

The authorities cited above establish beyond question that the surety has been granted the special protection of equity in return for having fulfilled its undertaking to answer for the debt, default or miscarriage of its principal, the defaulted contractor. Equity has granted the surety a lien, which is a property right in the balance of the contract price remaining in the hands of the Government. Each and every claim of the Government under the contracts bonded by the National Surety Corporation in this case has been satisfied. The two claims setoff, i. e., the tax claim for $206.53, did not arise until after the surety made its bonds and has no relation to the contracts bonded, and the claim for $2,552.43 arose under two Veterans' Administration contracts which were bonded by a surety other than National Surety Corporation. These claims bonded by another surety cannot be charged against the plaintiff. *United States Fidelity and Guaranty Company* v. *United States,* 92 C. Cls. 144.

There can be no doubt from the authorities cited that the law is well settled that the surety has an equitable lien upon the contract monies. The Government has no lien, legal or equitable. *United States* v. *Oklahoma,* 261 U. S. 253; *United States* v. *Giger,* 26 Fed. Supp. 624 (D. C. W. D. Ark); *United States* v. *Griswold,* 8 Fed. 496, 500 (Cir. Ct. Oregon). The claim of the United States to the asserted priority rests exclusively upon the statute. No lien is

created by it. It does not overreach or supersede any bona fide transfer of property in the ordinary course of business. While the United States has a priority on claims for taxes, such priority is in the assets of the estate, and it does not give priority over a valid lien. *United States Fidelity & Guaranty Company* v. *Sweeney,* 80 Fed. (2d) 235. The priority of the United States does not reach back over any valid lien, whether it be general or specific. *United States* v. *Sheriff of Charleston* (D. C. S. C.), Fed. Cas. No. 16276. Section 3466 does not give a lien to the United States; therefore, if a lien in favor of a third person has arisen before the right of the United States to a benefit has accrued the property is divested out of the owner, and cannot be made liable to the United States. *Lerman* v. *Lane Novelty Company,* 130 N. J. Eq. 141,21 Atl. (2d) 827. The United States has no lien in any event by virtue of Section 3466. *New York Casualty Company* v. *Zwerner,* 58 Fed. Supp. 473.

The United States is an unsecured creditor of the same class as unsecured creditors generally, though within its class it has the priority of payment given it by Section 3466 R. S. It now claims that this priority in such class of unsecured creditors elevates it to and above the higher level of the surety, which is secured by its equitable lien attaching to the contract money. But this literally would be lifting oneself by one's own bootstraps.

Even if the Government had a lien for its taxes under Section 3466 there is no property of the contractor to which the tax lien could attach

In the case of *F. H. McGraw Company* v. *Sherman Plastering Co., et al.* 60 Fed. *Sup.* 504, the United States District Court for Connecticut held that since the amount owed by the subcontractor to its materialmen exceeded the bal-

ance due it on the contract price, the subcontractor had no "right of property" in the unpaid contract, to which the Government's claimed lien for taxes could attach; that merely by assertion of the lien the rights of the Government rose no higher than those of the taxpayer whose right to property is sought to be levied on.

Where there is a default by the contractor, either in performance or in non-payment of laborers and materialmens' bills, the contractor has no property right in the unpaid balance of the contract price and therefore there is nothing against which a priority in favor of the United States can be claimed. *F. H. McGraw,* supra. *In re Van Winkle,* supra. *United States Fidelity & Guaranty Company* v. *United States,* 92 C. Cls. 144; *Martin v. National Surety Co.,* 300 U. S. 588; *In re Duncan,* 127 Fed. (2d) 640 (C. C. A. 3); *Karno-Smith v. Maloney,* 112 Fed. (2d) 690 (C. C. A. 3).

Since the surety is entitled to equitable as well as contractual subrogation in the contract price, it is plain that upon default the contractor had no right, title, or interest in such fund and therefore was without authority or power to assign the same. It could not deprive the surety of its right by an assignment. The defendant would have no right of priority with respect to moneys which its debtor had no right to assign since Sec. 3466 applies only to the assets of the debtor in the hands of its legal representative. *United States v. Oklahoma,* 261 U. S. 253.

Priority claims of the United States under Sec. 3466 are subordinate to the lien of a mortgage which has attached before the indebtedness to the Government accrues. *United States v. Guaranty Trust Co.,* 33 Fed. (2d) 533. C. C. A. 8)

The tax claim in the instant case was for the year 1935. The contracts involved were dated from November 18, 1933

to March 11, 1935. The tax did not accrue until after the date of the last contract. In connection with a possible assertion by the Government that it had a lien for the 1935 capital stock tax, it should be noted that on the Schenectady contract alone, Case No. 44999, where the contract is dated November 18, 1933, the surety had a loss of $45,754.49 (R. 341), which exceeds the total recovery in the Court of Claims plus the item of tax deductions and the charge for losses on other contracts. This contract was made more than a year before the year of the capital stock tax.

The right of the surety to receive the balance of the contract price is superior to the right of the defaulted contractor's assignee or trustee in bankruptcy

As this Court said in *United States* vs. *Oklahoma, supra,* the priority afforded the United States under Section 3466 attaches only to the assets in the hands of the insolvent debtor's legal representative. Therefore, the claim of the United States under Section 3466 must, in any event, be contingent upon the right of the assignee or a trustee in bankruptcy to receive the balance of the contract price in the fact of a claim by the surety who has performed under its bond.

In the case of *Lyttle* vs. *National Surety Company,* 44 App. D. C. 1936, there was an unexpended balance of the contract in the hands of the United States, and a contest arose between the surety who had paid the material bill, and the trustee in bankruptcy of the contractor for the fund. The Court, in awarding the money to the surety company, said:

> "The surety company, having a valid, equitable lien on this fund and being subrogated to the rights

> of the government to the extent of being reimbursed for the amount advanced under its obligation as surety, it is not clear just what claims could be asserted by the trustee to have the matter adjudicated in the bankruptcy court. The lien of the surety company against this fund was prior and superior to any claim shown to exist against the contractor or the trustee standing in his shoes. As against the contractor and likewise against the trustee, the equity which existed in favor of the surety existed not from the date of the bringing of the present suit but from the date of the bond."

In a very recent case, that of *California Bank* vs. *United States Fidelity and Guaranty Company*, 129 Fed. (2d) 751, (C. C. A. 9), decided July 27, 1942, which involved questions concerning the surety's right to subrogation upon a building contract with the Government, the court, in the course of its opinion, stated as follows:

> "Thus, in consequence of Anderson's (Anderson was the contractor) default, the $37,170.04 then in the hands of the United States became a fund which the United States was entitled to apply to the payment of materialmen's claims, and which appellee, as subrogee of the United States, was entitled to have applied in reimbursement of the $21,609.28 expended by it in paying such claims; and appellee's right to have the fund so applied *was superior to any right of Anderson or Anderson's assignees—if any.*" (Italics supplied.)

Other cases holding that the right of the surety is superior to the right of the defaulted contractor's assignee or trustee in bankruptcy are:

National Surety Co. v. *Lane*, 45 App. D. C. 176;
Philadelphia Bank v. *McKinlay*, 63 App. D. C. 296, 72 F. (2d) 89;
Moran v. *Guardian Casualty Co.*, 64 App. D. C. 188, 76 F. (2d) 438.

The Court of Claims in mis-applying Section 3466 put the United States, a general creditor, ahead of the surety, secured by a lien, which gave it a property right in the balance of the contract price. This is patently wrong because if it were good law any general creditor would have the same right, subject only to the priority of the United States. The priority does not elevate the United States out of this unsecured class. Despite its priority *within its class*, it still is subordinate to persons in higher legal relationship to the contract money.

The Court of Claims made reference to *United States* vs. *National Surety Company*, 254 U. S. 73, as supporting the position taken in this case. That case is not at all in point. That was a case where the bond penalty was only $3,150.00 whereas the Government's loss because of the contractor's default was $13,000.00. Payment by the surety of the full penalty of the bond left the United States with an unpaid loss of $9,850.00 on the contract bonded. It always has been the law that the surety's equitable lien does not attach where the loss of the obligee *on the contract bonded* is not satisfied in full by the surety. But that is not to say that the United States has the right, after it has been paid in full its loss on the contract bonded, to charge against a surplus of the contract price the collateral and unrelated debts owed by the contractor to the United States. The Court of Claims said in categorical language in the *Maryland Casualty Company case, supra*, that the United States did not have the right to offset taxes or unrelated debts of the contractor against the interest of the surety.

Conclusion

The question is one of importance. It involves the rights of surety in every case where the defaulted contractor is indebted to the United States for taxes. Such cases will

occur in increasing numbers in the future and will directly affect the surety industry. It is respectfully submitted that the decision below marks a distinct departure from the rationale of similar cases decided in its own court and in this Court, and should, therefore, be reviewed.

For the reasons stated, it is respectfully submitted that this petition should be granted.

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APPENDIX

Section 3466, R. S., 31 U. S. C. Sec. 191, reads as follows:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."